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IN THE

Supreme Court of the United States

OCTOBER TERM, 1956.

No. 323

H. C. HAMMER, MORRIS NORIAN AND RICHARD NORIAN,

Petitioners,

vs.

CHARLES W. SANDERS, JOHN L. FYE AND O. R. THOUREEN, INDIVIDUALLY AND AS CO-PARTNERS DOING BUSINESS AS THE SANDERS-FYE DRILLING COMPANY,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF ILLINOIS.

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Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE SUPREME COURT OF ILLINOIS.

Petitioners, H. C. Hammer, Morris Norian, and Richard Norian, the plaintiffs, pray that a writ of certiorari issue to review the judgment of the Supreme Court of Illinois.

OPINION BELOW.

The opinion of the Illinois Supreme Court is officially reported at 8 Ill. 2d 414, 134 N. E. 2d 509. The dissenting opinion of three of the seven judges commences at 8 Ill. 2d 425, 134 N. E. 2d 515. Appendix B of this petition contains the majority opinion at pages iii to xiv, and the dissenting opinion at pages xv to xxi. Both opinions are also contained in the certified record at pages 7 to 19.

JURISDICTION.

The judgment of the Illinois Supreme Court, a copy of which is contained in Appendix B to this petition, was entered on March 22, 1956. (R. 20-21.) Rehearing was denied on May 22, 1956. (R. 24.)

The jurisdiction of this court is invoked under the Judicial Code, 62 Stat. 929, 28 U. S. C. 1257(3).

QUESTION PRESENTED.

Petitioners are investors. Respondents are promoters and drillers of oil wells. The question is whether forty-five fractional undivided interests in oil and gas leases, which respondents sold to petitioners, are securities under the Federal Securities Act of 1933; or whether they are outside the definition of securities because respondents artfully cast them not merely as sales of fractional undivided interests but also as "drilling agreements".

Three justices of the Illinois Supreme Court held that the instruments were securities under the definition of the Federal Securities Act of 1933. Four justices denied relief to petitioners, refraining from considering the Federal question although petitioners' raising of the Federal question was timely and proper.

STATUTE INVOLVED.

The pertinent portions of the Federal Securities Act of 1933 are:

1. Section 2(1) of the Federal Securities Act of 1933, Tit. I § 2(1), 48 Stat. 74, 905, 15 U. S. C. 77(b)(1):

> The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorgan-

ization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

2. Section 2(3) of the Federal Securities Act of 1933, Tit. I § 2(3), 48 Stat. 74, 15 U. S. C. 77(b)(3):

> * * * Any security given or delivered with, or as a bonus on account of, any purchase of securities or any other thing, shall be conclusively presumed to constitute a part of the subject of such purchase and to have been sold for value. * * *

STATEMENT OF THE CASE.

This case is a consolidation of three actions instituted by petitioners. In fifty-one separate transactions between May 26 and October 24, 1952, respondents through their salesmen and solicitors sold to petitioners unregistered fractional undivided interests in oil and gas leases for amounts totaling $78,596.40. Except for two invoices covering six interests (R. 2:42, 2:108), respondents effected each sale of securities by letter agreements which were identical in form, differing only as to date, location of the oil and gas lease, amount of the fractional interest sold, and money consideration. One of the letter agreements appears in the majority opinion at pages iv-v of Appendix B. Respondents retained a one-fourth fractional interest in each lease (R. 2:129-130), and sold all remaining fractional interests to numerous investors whose identity they refused to disclose even upon deposition in the trial court. (R. 2:166-170.)

For money consideration, each letter agreement expressly sold to the investor an undivided fractional working interest in an oil and gas lease "for investment purposes only," and at the same time included respondents' agreement to drill for oil to a specified depth. The same money consideration served for both the drilling and the purchase of the undivided fractional oil and gas lease interest. The investor had no further obligation at all, unless a producing well came in. Then the investor was to be charged with his share of the expense of completing and operating the well. For each one of the fifty-one interests sold, respondents invoiced petitioners for a "working interest". (R. 2:10-43, 2:57-64, 2:77-110.) Of the 51 separate sales, 39 were dry holes, representing most of petitioners' investments.

Under both the Federal Securities Act of 1933 and the Illinois Securities Law, petitioners tendered all interests back to respondents, and respondents refused the tenders. Petitioners then filed actions under both the Illinois and Federal Securities Acts to recover the amounts paid. The trial court gave judgment for the petitioners. On appeal, however, the Illinois Appellate Court reversed the judgment, holding that the transactions were not sales of securities and that there was no proper tender. (6 Ill. App. 2d 346, 127 N. E. 2d 492.) The Illinois Supreme Court granted leave to appeal.

The Illinois Secretary of State, who is charged with the administration and enforcement of the Illinois Securities Law, obtained permission to appear as *amicus curiae* on the ground of major public importance, and urged the Illinois Supreme Court to find that the letter agreements were securities.

As to forty-five of the fifty-one sales, the Illinois Supreme Court affirmed the judgment of the Appellate Court,

and held that the letter agreements were not securities under the Illinois Securities Law. As to the six transactions covered by two invoices and not by letter agreements, the Illinois Supreme Court held that they were sales of securities under the Illinois Securities Law. The majority opinion refrained from passing on whether the letter agreements were securities under the Federal Securities Act of 1933.

HOW FEDERAL QUESTION IS PRESENTED.

A Federal question was properly raised by petitioners' complaints at the moment they were filed in the court of first instance, the Circuit Court of Cook County, Illinois. The complaints consisted of two counts. Count I alleged that the transactions violated the Illinois Securities Law (R. 2:1-6, 2:49-54; 2:68-74), and Count II, which is contained in Appendix C to this petition, alleged that the transactions violated the Federal Securities Act of 1933. (R. 2:7-8; 2:54-55; 2:74-75.)

The majority Illinois opinion below expressly states (Appendix B vi):

> "By their complaints, filed in February, 1953, the plaintiffs sought to rescind the transactions and recover all sums expended by them. They alleged a violation of both the Illinois Securities Act of 1919 *and the Federal Securities Act of 1933.*" (Emphasis supplied.)

Nevertheless, the majority Illinois opinion failed to consider the violation of the Federal Securities Act of 1933. Its failure to do so is commented upon in the dissenting opinion (Appendix B xv) as follows:

> "* * * nor (can we) understand their (majority of the court) failure to consider the charge of violation of the Federal Securities Act, as alleged in Count II

of the complaint and assigned as error and so argued by plaintiffs. These transactions cannot be placed outside the purview of the State or Federal Securities Acts without ignoring the plain language of the statutes and the clear economic import of the transactions."

REASONS FOR GRANTING THE WRIT.

1. The Illinois Decision Creates a Serious Public Enforcement Problem. If It Stands, It Would Permit Easy Circumvention of the Federal Securities Act of 1933 in Sales of Oil Securities.

Oil and gas ventures are particularly vulnerable to irresponsible promotions upon a credulous or ignorant public. The history of the exploitation of oil and gas rights is one of great commercial and economic development, with concurring wildcat speculation and fraudulent and deceitful promotions.

The Illinois decision construing the definition of "security" as it affects contracts for exploiting oil presents a matter of major public importance in the administration and enforcement of the Federal Securities Act. If it is allowed to stand, the Illinois decision creates a simple method to circumvent the plain requirements of the Act in the sale of oil securities. Urgent and compelling considerations of public policy make it necessary that the writ be granted.

The majority Illinois opinion, by its hyper-technical and basically impractical analysis of the transactions before the Court, would create a potentially powerful instrument for fraudulent promotions to bilk the public. It would serve judicially to abrogate the clear language and intention of the Congress and to foster the abuses which Congress intended to end.

2. In the Sale of Oil Securities, Promoters Have Devised a Great Variety of Forms, Which the Federal Securities Act of 1933 Was Designed to Regulate. Respondents' Device Is Clearly Within the Terms of the Act.

Methods of oil and gas financing by the sale of securities have assumed a great variety of forms devised by the ingenuity and shrewdness of blue sky violators. By the breadth of the language used, Congress sought to bring the widest variety of security sales within the Act, and to prevent the unregulated use of devious and ingenious schemes. This Court itself has said that oil and gas rights have been such notorious subjects of speculation and fraud that they posed a difficult problem for the legislative draftsman. *Securities & Exchange Commission* v. *Joiner*, 320 U. S. 344, 352.

As illustrations of the breadth of the devices which courts have brought under securities laws, we have compiled in Appendix A a tabulation of forms used by oil and gas promoters which have come under appellate judicial scrutiny, and of the court decisions which have passed on them. The forms used by defendants to sell their oil securities clearly fall under the Act.

Congress intended to encompass all sales of oil securities by the definition in the Act. Short of a word by word description of every wildcat scheme that might be imagined by promoters to separate an investor from his money, it is difficult to see how the draftsmen of the Act could have described the instrument in question more clearly than a "fractional undivided interest in oil, gas, or other mineral rights." By judicial gloss and contrary to the legislative intent, the Illinois Supreme Court has excised an entire class of dealing from the plain language of the Act. Without indicating in any way that the language is vague, indefinite, or void, the Illinois court merely disregarded it.

3. Respondents' Simultaneous Sale of the Oil Security and Their Agreement to Drill a Well, Both for the Same Money Consideration, Constitute a Sale of a Security Under the Act, and Not a "Drilling Agreement" Outside the Act.

The letter agreements, artfully drafted by the defendants, are securities within the definition of the Act. They expressly refer to the acquisition and assignment for money of undivided working interests in oil and gas leases "for investment purposes only," as both parties stated.

Nevertheless, the majority Illinois opinion held that the transactions were not sales of securities because the development contract aspects of the instruments were "uppermost" in the minds of the parties and the money which petitioners paid was for drilling costs and not for the purchase of undivided fractional interests in oil and gas leases. The majority view is hardly a realistic one.

As the Illinois dissenting opinion points out (Appendix B xix), petitioners invested money for undivided fractional interests and with the understanding that respondents would drill wells. But the drilling of the well, in itself, would benefit petitioners not at all unless they received, for their investment, a right to share in the oil benefits reaped by the drilling efforts. There was no provision in the letter agreement for any further payment to acquire a fractional undivided working interest, since the letter agreement itself constituted such a sale. The only additional provision was to bear a proportionate part of well expenses if a producing well ensued.

The Illinois decision is in direct conflict with the applicable holdings of this Court in *Securities & Exchange Commission* v. *Howey Co.*, 328 U. S. 293, and *Securities & Exchange Commission* v. *Joiner*, 320 U. S. 344. In language

which applies forcefully to the instruments in this case, this Court stated in the *Joiner* opinion:

> It is clear that an economic interest in this well-drilling undertaking was what brought into being the instruments that defendants were selling and gave to the instruments most of their value and all of their lure. The trading in these documents had all the evils inherent in the securities transactions which it was the aim of the Securities Act to end. (P. 349.)

Even if it be assumed, as the Illinois majority opinion says, that "at best, the transfer of a working interest was incidental to the development contract" (Appendix B xi), the Illinois majority conclusion is contrary to the provisions of Section 2(3) of the Federal Securities Act, quoted above at page 3.

In effect, the Illinois majority opinion states:

> The money was for drilling costs. The fractional undivided oil and gas lease interests were free. Therefore, there was no sale of securities.

If this doctrine prevailed, the Act could be circumvented by the most obvious devices. In any sale of oil securities, the consideration could easily be ascribed to any related aspect other than the security, and the Act would be avoided.

It was precisely to prevent the situation which as now arises under the Illinois majority opinion, that Congress provided in Section 2(3) a conclusive presumption, regardless of what aspect is "uppermost" in the minds of the parties. In the instant case, the conclusive presumption legally ascribes the "consideration paid" to the sales of working interests and not to drilling costs.

In discussing Section 2(3) of the Act, Loss on Securities Regulation (1951) says:

> "Bonus" Stock: Section 2 (3) makes specific what

> would probably have been the construction in any event: "Any security given or delivered with, or as a bonus on account of, any purchase of securities or any other thing, shall be conclusively presumed to constitute a part of the subject of such purchase and to have been sold for value." This is another way of stating the obvious proposition that, when a drug store gives a second tube of toothpaste "free" with every tube purchased for 50 cents, the cost is 25 cents per tube. (P. 332.)

See also *Whittaker* v. *Wall*, 226 F. 2d 868 (C. A. 8—1955).

If the controlling mandate of the Act were paraphrased to apply to the instant case, it would read:

> Any working interest given or delivered with, or as a bonus on account of payments made for drilling costs, shall be conclusively presumed to constitute a part of the subject of such purchase and to have been sold for value.

A judicial nullification of the statute would cause the utmost confusion and maladministration.

The trial court heard this cause on motions for summary judgment. Petitioners' affidavits for summary judgment expressly state that respondents sold the issues of oil securities in interstate commerce and by use of the mails and that the sales of the securities were not exempt. (R. 2:118 incorporating 2:1-49; 2:121 incorporating 2:68-117; and 2:125 incorporating 2:49-68.) Respondents had no affidavits nor motions in opposition to petitioners' motions for summary judgment. (R. 2:171-172.) In their own affidavits in support of their motion for summary judgment, respondents did not controvert petitioners' affidavits as to interstate commerce, use of the mails, or non-exemption. (R. 2:129-161.)

In Illinois on motion for summary judgment the supporting and opposing affidavits are controlling and the fact

that the pleadings join issue does not prevent the entry of a summary judgment. Petitioners' uncontradicted allegations in their affidavits are the undisputed facts of this case. To have prevented the entry of a summary judgment, respondents were obliged to file a sufficient affidavit of defense. This they failed to do. (*Killian* v. *Welfare Engineering Co.*, 328 Ill. App. 375, 384-385, 66 N. E. 2d 305, 310; *Roberts* v. *Sauerman Bros.*, 300 Ill. App. 213, 216-217, 20 N. E. 2d 849, 850.)

Respondents admittedly failed to register their securities. Respondents also failed to comply in any way with the information requirements of the liberal exemption which the Securities & Exchange Commission has granted to small issues of oil and gas securities (Securities & Exchange Commission, General Rules and Regulations, Regulation B, Rules 300 and 320, 2 Fed. Reg. 904-905, 13 CFR 230.300 and 230.320 (1937)) and which is conditioned upon the prior deposit of minimum information with the Commission.

That the instruments before the Court are securities is clearly shown by the definition of "working interests" which the Securities and Exchange Commission published on November 27, 1939, and has adhered to ever since. In its Form S-10 and instructions for registration of oil or gas interests under the Federal Securities Act of 1933, the Commission expressly made the following definition:

> The term "working interests" means fractional undivided interests in an oil or gas leasehold which are subject to any portion of the expense of *development*, operation, or maintenance.

(Emphasis supplied. Commerce Clearing House Federal Securities Law Reporter, vol. 1, pars. 7201-7202, p. 3691.)

Tax Treatment Does Not Abrogate Securities Act.

In order to encourage the flow of capital into the development of oil and gas resources, Congress has provided certain tax advantages which have greatly stimulated public purchases of oil and gas securities. Congress did not intend that tax laws or regulations should repeal the plain requirements of the Federal Securities Act of 1933. The fact that the taxpayer-investor may expense intangible drilling and development costs does not mean that Congress intended that oil and gas investments should be made on an uninformed basis. (Bloomenthal, S. E. C. Aspects of Oil and Gas Financing, 7 Wyo. L. J. (1953) 49, 63; Bloomenthal, A Guide To Federal Oil and Gas Income Taxation, 8 Wyo. L. J. (1954) 83, 97.)

Respondents pre-cast the instruments before the Court so as to achieve maximum benefits under the Internal Revenue Code. However, neither a tax consideration nor a promoter's device should subvert the public interest in adequately regulating oil securities. This Court looks to the substance of the transaction—the sale of a fractional undivided interest in an oil lease.

CONCLUSION.

One can hardly imagine a more flagrant enactment of judicial exemption than the Illinois majority opinion. If it stands, many, many of millions of dollars in oil and gas securities would escape all regulation under the Federal Securities Act of 1933. Administration of the Act would be in the utmost confusion. Clear sales of oil and gas securities would gain exemption whenever the seller would merely state that the consideration is going for some related purpose. The decision of the Illinois Supreme court ought to be reviewed.

The instruments before the Court are clearly sales of securities. Petitioners pray that a writ of certiorari be granted.

Respectfully submitted,

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August 17, 1956.